# INFLATION: WHY WAGES MATTER

Everything is getting more expensive. Prices for energy, food, and many other things are rising sharply. The European Central Bank has been trying to counteract this trend since June 2022: it has already increased interest rates four times and has announced further base rate hikes. But is this the right strategy? Political scientist Martin Höpner warns against overzealous monetary policy and recommends keeping an eye on wage trends.



Inflation appeared to have vanished. It was deflationary rather than inflationary pressure that plagued developed economies over the last two decades. There was little to indicate that that would soon change. Within just a year and a half we have landed in a different world. The last time that there were double-digit increases in consumer prices in Germany was during the Korean War in 1951 – and even then, only in two out of the four quarters.

Until the middle of 2022, the European Central Bank (ECB) refrained from counteracting the increase in prices with interest rate hikes. Their inaction drew severe criticism from Germany in particular, as the inflation rate of five percent in the second half of 2021 was already considerably above the target of two percent. The Central Bankers admit that the ECB reacted quite late – but when it did, it did so vigorously. Since July 2022, it has increased the main refinancing interest rate – the key base rate – four times, and it is hinting at further interest rate hikes. Now, I believe, that there is a danger of the ECB doing too much as a result of overzealousness. To be more precise, it irritates me that the ECB is not taking wage policy into account in its decisions. Let me explain what I mean by that.

→

# VIEW POINT

## MARTIN HÖPNER

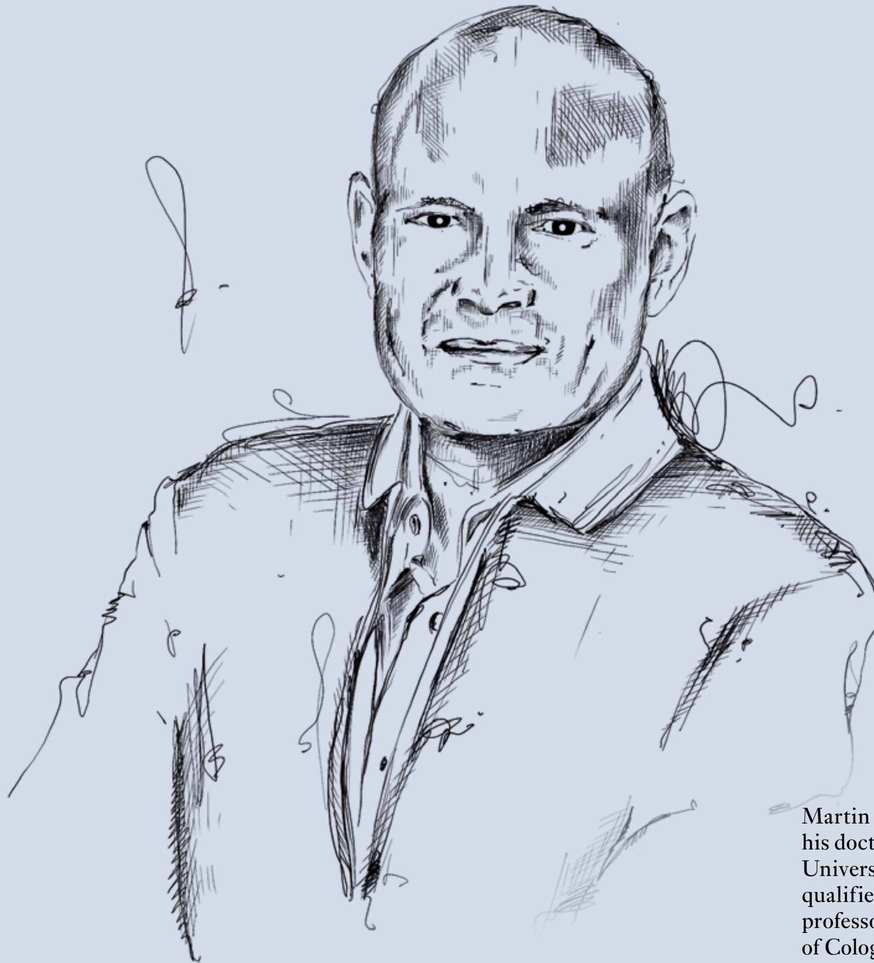

ILLUSTRATION: SOPHIE KETTERER FOR MPG

Martin Höpner completed his doctorate in 2002 at the University of Hagen. He qualified as a full university professor at the University of Cologne five years later. Since 2008, he has led an independent research group on the political economy of European integration at the Max Planck Institute for the Study of Societies in Cologne. Since 2012, he has also been a supernumerary professor at the University of Cologne. His research fields include the heterogeneity of the European economic and currency area, European single market freedoms, and the export-oriented German economic model.

To date, the causes of this inflation have predominantly been found on the supply side. During the pandemic, supply chain disruptions made primary products more expensive. There were also significant increases in energy prices, which fluctuated notoriously. While prices fell in 2020, they accelerated considerably in 2021. As we now know, that was only the beginning. Following the Russian attack on Ukraine and the resulting sanctions imposed on it, energy prices – particularly for natural gas – positively exploded. This has led to price increases across the board right up to the present time, as all products and virtually all services involve energy. Everything that money can buy is becoming more expensive.

Inflation with second-round effects, also referred to as wage-price spirals, is something different. This term is used to describe dynamics where prices and wages push one another up. Unions want to counteract the purchasing power losses suffered by their members and react to rising prices with rising wage demands, hard-fought industrial action, and ultimately high wage settlements. This further increases the cost pressure on firms, which are forced to increase prices in turn. This encourages unions to once again make high wage demands – and so on. Even if the initial causes of the price hikes are eliminated, inflation can be reinforced in this way. The fact that central banks have to stop such spirals through considerable interest rate increases is not in dispute.

UNIONS HAVE, TO DATE, REACTED TO THE PRICE INCREASES IN A VERY STABILITY-CONSCIOUS MANNER



The unions have, to date, reacted to the price increases in an extremely stability-conscious manner. Consider, for instance, the wage settlement reached in the German chemical sector in October 2022 or that in the metal industry in November. If you take into account the long terms of the wage agreements, the settlements were low (note also that the first wage increase in the metal industry was also preceded by an eight-month pay freeze). The unions are asking a lot of their members with wage agreements of this kind. There is no sign of wage-price spirals at present. I would go even further: the level of stability-focused wage policies that we are currently experiencing in Germany and also in other euro area countries to date is sensational. We didn't expect this. In my view, the ECB should take this into account and announce that it will increase interest rates further and quite significantly if second-round effects occur – but only then. Particularly in Germany, observers are currently encouraging the ECB to raise interest rates one way or another. They justify this by saying that it is necessary to reduce demand for goods and services. But this is the precise impact of a cautious wage policy anyway: the discrepancy between inflation and wage increases reduces real wages and hence demand.

Unfortunately, inflation will not disappear quickly even without second-round effects. This is evident from the gulf between the increase in producer prices, on the one hand, and consumer prices, on the other. Producer prices, which comprise manufacturing costs, including primary products, rose by not just ten percent or so in 2022 but by 30 to 40 percent. This means that there is still a lot of dormant cost pressure in firms, which will gradually be passed on to consumers. As a result, consumer prices are likely to continue to increase even when producer prices begin to fall again. Interest rate hikes would do nothing to change this. On the contrary, the increase in financing costs would add to the cost pressure that companies are facing.

If the ECB decides to increase interest rates in the medium term without taking wage responses into account, this may even increase the risk of second-round effects. Then there would be no disciplinary impact arising from the central bank's policy. Instead, the unions would be forced to conclude that how they respond to price rises obviously makes no difference to the level of base rates. But that's not all. By raising interest rates, the central bank would lower the refinancing capacity of states, which would then find it more difficult to ease the burden on poor households. Without state relief, however, unions would be left with no alternative but to provide relief by means of wage policy – but then with direct cost pressure impacts for businesses.



INFLATION REPRESENTS AN ENORMOUS ENDURANCE TEST FOR THE EURO AREA

How inflation develops in the medium term thus depends on wage policy. This is one of the reasons why we at the Max Planck Institute for the Study of Societies are devoting particular attention to wage policy. In the near future, a problem could arise from the fact that there is in truth not "one" wage policy in the euro area; instead, there are 19 different ones with different institutions, power relations, problem perceptions, and response patterns to economic shocks. The ECB can respond in an ordered fashion to uniform wage policy reactions – even if to the detriment of growth and employment – but not to 19 different ones.

To date, there have been few indications of wage-price spirals in other countries in the euro area either. But we don't know whether that will remain the case. If there is no accord with respect to wage policy responses, significant inflation spreads may emerge within the eurozone. This is precisely what happened during the first ten years of the euro, when the competitiveness of the countries with higher inflation rates deteriorated and their ability to refinance their national debt hit rock-bottom. This resulted in the euro crisis. Inflation thus represents an enormous endurance test for the euro area. The euro is not yet out of the woods.